CONCEPT: DYNAMIC AD-AS MODEL – EXPANSIONARY AND CONTRACTIONARY FISCAL POLICY

● The *dynamic AD-AS model* fixes some of the issues with the AD-AS model by removing some key assumptions

  ▫ The dynamic AD-AS model incorporates:

  > Potential GDP increases over time → LRAS shifts _____

  > Aggregate supply tends to increase over time → SRAS shifts _____

  > Aggregate demand tends to increase over time → AD shifts _____

  ▫ When the economy is *in recession*, real GDP is below its potential output

  > *Expansionary fiscal policy* – Government _____ spending to stimulate economy

  - The government can also _____ taxes (which _____ consumption)

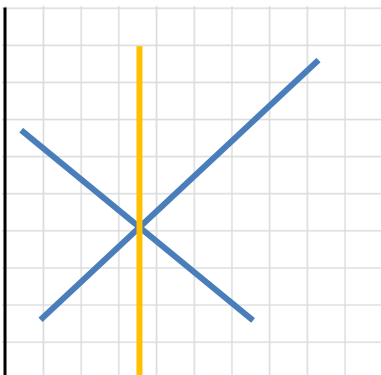Expansionary Fiscal Policy
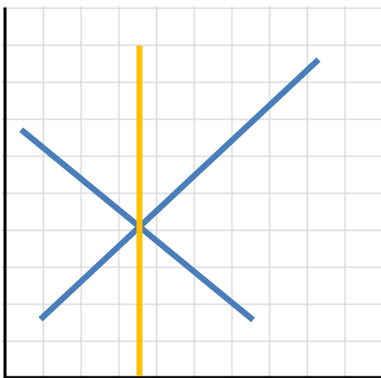
Dynamic AD-AS Model

1. Equilibrium is initially at Point A on the graph
2. Dynamic model increases to AD, SRAS, and LRAS
3. AD did not grow enough to reach the new LR equilibrium
4. New SR equilibrium is at Point B
5. Expansionary Fiscal Policy boosts AD
6. Economy is at potential GDP (LR equilibrium; Point C)

  ▫ When the economy is experiencing *rising inflation*, real GDP is above its potential output

  > *Contractionary fiscal policy* – Government _____ spending to reduce inflation

  - The government can also _____ taxes (which _____ consumption)

Contractionary Fiscal Policy

Dynamic AD-AS Model

1. Equilibrium is initially at Point A on the graph
2. Dynamic model increases to AD, SRAS, and LRAS
3. AD grew too much and passed the new LR equilibrium
4. New SR equilibrium is at Point B
5. Contractionary Fiscal Policy reduces AD
6. Economy is at potential GDP (LR equilibrium; Point C)